

Part III - Administrative, Procedural, and Miscellaneous

Life Insurance Reserves -- Actuarial Guideline XLIII

Notice 2010-29

SECTION 1. PURPOSE

This notice provides interim guidance to issuers of variable annuity contracts on issues that arise under §§ 807 and 816 of the Internal Revenue Code (Code) as a result of the adoption by the National Association of Insurance Commissioners (NAIC) of Actuarial Guideline XLIII, Commissioners' Annuity Reserve Valuation Methodology (CARVM) for Variable Annuities (AG 43).

SECTION 2. BACKGROUND

Overview

.01 A life insurance company is required to account for its obligations to policyholders using reserve methods of accounting. Statutory Accounting Principles (SAP) govern the preparation of the company's annual statement, which is filed with the relevant state insurance regulators. Generally Accepted Accounting Principles (GAAP) govern the preparation of an insurer's financial statements, which are provided to shareholders, bondholders, banks and rating agencies. GAAP differs in some respects from SAP.

.02 Clear reflection of the income of a life insurance company for federal income tax purposes requires an appropriate measurement of the company's life insurance reserves. Tax accounting rules used to compute the taxable income of a life insurance

company differ in some respects from SAP or GAAP, including with respect to the computation of life insurance reserves.

.03 Although all insurance companies are required by the respective states in which they do business to maintain reserves, not all reserves that a company maintains (or is required to maintain) qualify as "life insurance reserves" for Federal income tax purposes.

Use and Computation of Life Insurance Reserves

.04 Under § 816(a), an insurance company is a life insurance company if the sum of (1) its life insurance reserves, plus (2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, accident, or health policies not included in life insurance reserves, comprise more than 50 percent of its total reserves.

.05 Section 816(c) defines "total reserves" as the sum of (1) life insurance reserves, (2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and (3) all other insurance reserves required by law.

.06 Section 816(b) defines "life insurance reserves" as amounts that are (1) computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and (2) set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable accident and health insurance contracts (including life insurance or annuity contracts combined with noncancellable accident and health insurance) involving, at the time with respect to which the reserve is computed, life, accident, or health contingencies. Reserves generally must be required by law to qualify as life insurance reserves. See also § 1.801-4(d) and (e) (setting forth reserves that qualify,

and reserves that do not qualify, as life insurance reserves for Federal income tax purposes under the predecessor of § 816); Rev. Rul. 67-435, 1967-2 C.B. 232 (concluding that a reserve maintained for abnormal mortality or depreciation and losses on assets owned by the company is not a life insurance reserve).

.07 A life insurance company must pay tax on its “life insurance company taxable income,” which is defined in § 801(b) as life insurance gross income less life insurance deductions. Life insurance gross income is defined in § 803(a) to mean the sum of (i) premiums, (ii) net decreases in certain reserves under § 807(a), and (iii) other amounts generally included by a taxpayer in gross income. Life insurance deductions are defined in § 804 to mean the general deductions provided under § 805 and the small life insurance deduction (if any) determined under § 806. Section 805(a)(2) authorizes a deduction for the net increase in certain reserves under § 807(b). The reserves taken into account under § 807(a) and (b) include life insurance reserves (as defined in § 816(b)). See § 807(c)(1).

.08 Section 807(d) through (f) sets forth rules to compute the amount of the life insurance reserve for a contract for purposes of determining taxable income. Section 807(d)(1) provides that the amount of the life insurance reserve for any contract is the greater of the net surrender value of the contract (determined under § 807(e)(1)) or the federally prescribed reserve determined under § 807(d)(2). This amount cannot, however, exceed the amount that would be taken into account with respect to the contract in determining “statutory reserves” (as defined in § 807(d)(6)).

.09 Section 807(e)(1) provides that the net surrender value of any contract is determined with regard to any penalty or charge that would be imposed on surrender

but without regard to any market value adjustment on surrender (except for certain modified guaranteed contracts defined in § 817A(d)).

.10 Section 807(d)(2) provides that the federally prescribed reserve for a contract is computed using (a) the "tax reserve method" applicable to the contract, (b) the greater of the applicable Federal interest rate ("AFIR") or the prevailing State assumed interest rate ("PSAIR"), and (c) the prevailing commissioners' standard tables for mortality and morbidity, adjusted as appropriate to reflect the risks (such as substandard risks) incurred under the contract which are not otherwise taken into account.

.11 In the case of a contract to which the Commissioners' Annuities Reserve Valuation Method ("CARVM") applies (generally, an annuity contract), § 807(d)(3)(A)(ii) and 807(d)(3)(B)(ii) provides that the tax reserve method applicable to the contract is the CARVM as prescribed by the NAIC which is in effect on the date the contract is issued. Other parameters, such as the appropriate interest rate and mortality tables, are likewise generally determined with reference to the date the contract is issued.

.12 Section 807(d)(6) provides that the term "statutory reserves" means the aggregate amount set forth in the annual statement with respect to items described in § 807(c). See also Rev. Rul. 2008-37, 2008-2 C.B. 77 (statutory reserves under § 807(d)(6) equal the highest aggregate reserve amount for § 807(c) items actually held and set forth on the annual statement pursuant to the minimum reserve requirements of any state in which a taxpayer does business). The term does not, however, include any reserve attributable to a deferred and uncollected premium if the establishment of such a reserve is not permitted under § 811(c).

.13 Section 807(f) provides that if the basis for determining any item referred to in § 807(c) (for example, life insurance reserves taken into account under § 807(c)(1)) as of the close of any taxable year differs from the basis for that determination as of the close of the preceding taxable year, then so much of the difference between the amount of the item at the close of the taxable year computed on the new basis, and the amount of the item at the close of the taxable year computed on the old basis, as is attributable to contracts issued before the taxable year is taken into account ratably for each of the succeeding ten taxable years.

.14 Notice 2008-18, 2008-5 I.R.B. 363, was published on February 4, 2008, and described two reserve methodology projects that were then in development by the NAIC: One would provide a principles-based approach for calculating statutory reserves for life insurance contracts (Proposed Life PBR); the other, which was subsequently adopted as AG 43, would set forth a new Actuarial Guideline that would constitute CARVM for variable annuities (Proposed AG VACARVM). Notice 2008-18 alerted life insurance companies to federal income tax issues that could arise as a result of the adoption of either project and requested comments on those issues. Several organizations submitted comments in response to the notice.

Adoption of AG 43

.15 The NAIC adopted Proposed AG VACARVM as AG 43 with regard to contracts issued on or after January 1, 1981, effective December 31, 2009. Section V of AG 43 provides, however, that where the application of AG 43 produces higher reserves than a company had otherwise established by its previously used interpretation, the company may request a grade-in period, not to exceed three years,

from the domiciliary insurance commissioner upon satisfactory demonstration of the previous interpretation, and that such a delay of implementation will not cause a hazardous financial condition or potential harm to policyholders.

.16 The purpose of AG 43 is to interpret the standards for the valuation of reserves for variable annuity and other contracts involving certain guaranteed benefits similar to those offered with variable annuities. Generally, AG 43 requires that the aggregate reserve for contracts falling within its scope equal the Conditional Tail Expectation Amount (the “CTE Amount”)¹ but not be less than the Standard Scenario Amount.²

.17 Based on the requirements of §§ 807 and 816, the terms of AG 43, and the data that are available to date, the Treasury Department and the Internal Revenue Service (IRS) have reached interim conclusions as to some of the issues identified in Notice 2008-18 and are continuing to consider others. Accordingly, section 3 of this notice provides interim guidance to taxpayers on some of the issues that arise under AG 43.

SECTION 3. INTERIM GUIDANCE

.01 Reserve Ratio Test. For purposes of determining under § 816(a) whether an insurance company satisfies the 50 percent of reserves test for qualification as a life

¹ The CTE Amount is determined based on a projection of contracts falling within the scope of AG 43, and the assets supporting these contracts, over a broad range of stochastically generated projection scenarios and using prudent estimate assumptions. Although the CTE Amount is determined on an aggregate basis for the contracts falling within the scope of AG 43, Appendix 6 of the Guideline provides a method for allocating the aggregate reserve to individual contracts based on each contract's cash surrender value or Standard Scenario Amount, as applicable.

² The Standard Scenario Amount is the aggregate of the reserves determined by applying the standard scenario method (as outlined in Appendix 3 of AG 43) to each of the contracts falling within the scope of AG 43.

insurance company for taxable years ending on or after December 31, 2009--

(a) the Standard Scenario Amount determined under AG 43 is included in life insurance reserves as defined in § 816(b) and total reserves as defined in § 816(c); and

(b) a taxpayer that delays implementation of AG 43 with permission of its domiciliary insurance commissioner under section V of AG 43 must consistently delay implementation for purposes of determining life insurance reserves and total reserves under § 816(b) and (c).

.02 Statutory Reserve Cap. For purposes of applying the statutory reserve cap of § 807(d)(1) for taxable years ending on or after December 31, 2009 --

(a) the term "statutory reserves" under § 807(d)(6) includes the Standard Scenario Amount determined under AG 43. Thus, a reserve will not be excluded from statutory reserves under § 807(d)(6) solely because the reserve represents the Standard Scenario Amount determined under AG 43, provided the requirements of § 807(d)(6) are otherwise met. For example, under § 807(d)(6) statutory reserves do not include any amount attributable to a deferred and uncollected premium if the establishment of such reserve is not permitted under § 811(c); and

(b) to the extent that a taxpayer delays implementation of AG 43 with permission of its domiciliary insurance commissioner under section V of AG 43, it must consistently delay implementation for purposes of determining the amount of statutory reserves under § 807(d)(6).

.03 Federally-Prescribed Reserve. For purposes of determining the amount of the reserve under § 807(d)(2) with respect to a contract falling within the scope of AG 43 and issued on or after December 31, 2009, the provisions for determining the

Standard Scenario Amount are taken into account, and the provisions for determining the CTE Amount are not taken into account. Accordingly--

(a) for a contract issued before December 31, 2009, the tax reserve method under § 807(d)(2)(A) and (d)(3) is the method applicable to such contract when issued, as prescribed under relevant actuarial guidance in effect before the adoption of AG 43; and

(b) for a contract falling within the scope of AG 43 and issued on or after December 31, 2009, the tax reserve method with respect to such a contract under § 807(d)(2)(A) and (d)(3) is the method prescribed in AG 43 for determining the Standard Scenario Amount, applied using the appropriate valuation interest rate under § 807(d)(2)(B) and other adjustments to the method described below. See, e.g., AG 43, Appendix 3;

(c) the PSAIR under § 807(d)(2)(B)(ii) and (d)(4)(B) with respect to such a contract is the highest assumed interest rate permitted to be used in computing the Standard Scenario Amount for annuity contracts falling within the scope of AG 43 under the insurance laws of at least 26 states, as of the beginning of the calendar year in which the contract was issued;

(d) the prevailing commissioners' standard tables with respect to such a contract under § 807(d)(2)(C) and (d)(5) means the most recent commissioners' standard tables prescribed by the NAIC that are permitted to be used in computing the Standard Scenario Amount for such a contract under AG 43 under the insurance laws of at least 26 states when the contract was issued; and

(e) whether a taxpayer delays implementation of AG 43 with permission of its

domiciliary insurance commissioner under section V of that guideline has no effect on the determination of the amount of the reserve under § 807(d)(2).

.04 Ten-year spread. If the amount determined under § 807(d)(1) as of the last day of the first taxable year ending on or after the date of a taxpayer's implementation of AG 43 (generally, December 31, 2009) differs from the amount that would have been determined as of that date had AG 43 not been implemented--

(a) the difference between the amount determined with regard to AG 43 and the amount determined without regard to AG 43 (i.e., under prior actuarial guidelines) must be spread over 10 taxable years, using the method prescribed by § 807(f)(1)(B); and

(b) to the extent that a taxpayer delays implementation of AG 43 with permission of its domiciliary insurance commissioner under section V of that guideline, it must consistently delay implementation of the ten-year spread under this section 3.04.

.05 Standard Scenario Amount. The Standard Scenario Amount determined under AG 43 will be treated as a life insurance reserve for Federal income tax purposes if the requirements of that guideline, including the account value return assumptions, are met.

.06 Reliance on interim guidance. Taxpayers may rely upon the interim guidance provided in this notice pending further published guidance by the Treasury Department and the IRS. If, and to the extent, future published guidance differs from the interim guidance in this notice, the different provisions of that future guidance will be applied without adverse retroactive effect.

.07 No Inference on prior actuarial guidelines or Life PBR, or on other tax issues. No inference should be drawn from this notice regarding any federal tax issues that

arise under any actuarial guideline other than AG 43 or that could arise under Life PBR. In addition, this notice is not intended to address any other federal tax issues implicated in the adoption of AG 43 by the NAIC.

SECTION 4. EFFECTIVE DATE

This notice is effective **[INSERT DATE ON WHICH THIS NOTICE IS MADE AVAILABLE TO THE PUBLIC]**.

SECTION 5. PROCEDURAL INFORMATION

This notice serves as an "administrative pronouncement" as that term is used in § 1.6662-4(d)(3)(iii) of the regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.

DRAFTING INFORMATION

The principal author of this notice is Chris Lieu of the Office of the Associate Chief Counsel (Financial Institutions & Products). For further information regarding this notice, contact Mr. Lieu at (202) 622-3970 (not a toll-free call).